APPENDIX

James L. Kichline
June 29, 1982

CHART SHOW -- INTRODUCTION

During our presentations this afternoon we will be referring to the package of chart materials distributed to you. The first chart in the package displays the principal assumptions that underlie the staff forecast. For monetary policy, we have assumed M1 growth of 5 percent this year and 4½ percent in 1983, which is presented as long-run strategy 1 in the Bluebook. The fiscal policy assumptions include about $40 billion of expenditure cuts and tax increases for fiscal 1983, equal to roughly three-fifths of the actions contemplated in the first concurrent budget resolution. We also have assumed the multiyear personal tax rate reductions will be implemented as scheduled, consistent with the budget resolution.

The next page provides additional information on the federal budget outlook. The top panel shows the outlay, receipts, and deficit figures in the first resolution and the staff forecast. We do not yet have available administration estimates which are to be presented to the Congress in mid-July. For the current fiscal year the estimates are quite close, but they diverge considerably for 1983. Reconciliation of the deficits in 1983 is shown in the lower panel. The largest difference is accounted for by the underlying economic situation--higher unemployment and lower income--that influences both outlays and receipts. For example, the concurrent resolution has a projection of nominal GNP growth during 1983 of

11½ percent compared to 7½ percent in the staff forecast. The other major difference reflects our assessment that it is unlikely that all of the tax and expenditure changes envisaged in the resolution will be achieved. On balance, we still perceive the federal budget to be a stimulative force over the forecast period.

In contrast, we view monetary policy as a restraining force, as shown on the next chart. The implied M1 velocity growth this year and next does not appear unusual from the perspective of the last few years. But following the drop of velocity in the first half of 1982, we have built in an assumed willingness of the public to use existing balances more intensively to finance activity in the second half, as discussed in the Bluebook. During 1983, M1 growth of 4½ percent entails some downward shift of money demand given income and interest rates, according to the quarterly econometric model. As shown in the lower panel it seems to us that the monetary assumptions and economic environment imply continued high interest rates. To be sure, there is a great deal of uncertainty attaching to the interest rate outlook, but history doesn't seem to offer substantial encouragement for sizable rate declines in this forecast.

Mr. Zeisel will continue the presentation with a discussion of domestic nonfinancial developments.

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Joseph S. Zeisel
June 30, 1982

FOMC CHART SHOW

There have been some persuasive indications recently that the contraction is drawing to a close, although few signs as yet of significant recovery. Consumer demand has been lending the major support to final demands. As the upper left hand panel of the next chart indicates, total retail sales in real terms have been trending up since year-end, and in May were about 4-1/2 percent above the January level.

Auto demand, in particular, has strengthened, although the drop in sales in June following termination of most price incentives has caused some concern. Nevertheless, sales of domestic models have exceeded sharply reduced production levels for the past half year, laying the basis for a rise in auto production.

The improvement in auto output has been the major factor in the upturn in consumer durable goods production, shown in the lower left hand panel, and--along with expanding defense production--has helped stabilize overall industrial output. In contrast, output of business equipment and basic metals have continued to weaken.

As the lower right panel shows, both employment and the workweek have shown signs of leveling off, although the continued high flow of unemployment insurance claims suggests that employment and production adjustments have not been completed.

The next chart presents our view of the outlook for real GNP growth through the balance of this year and in 1983. The expected resumption of growth in the second half reflects in part the end of stock liquidation. But the major support for sustained growth should be provided by increases in personal consumption outlays in response to the tax cuts in mid-1982 and again in 1983. Nevertheless, the momentum of the recovery overall remains severely constrained as high interest rates inhibit business spending and housing activity, government continues to curb non-defense outlays, and exports are damped by the strength of the dollar. On balance, real GNP is expected to increase at under a 3 percent rate over the next 6 quarters, well short of a normal cyclical recovery.

As the bottom panel shows, this rate of rise is only a little more than the growth of economic potential, leaving the economy with a considerable degree of underutilized resources throughout the next year and a half.

The next chart portrays our view of the outlook for consumption. It is our judgment that consumers will respond in a traditional way to the increase in disposable income from the personal tax cut: we have assumed that they will spend some two-thirds of the extra income within half a year. But as a comparison of the two top panels indicates, absent sustained income gains generated in other sectors, growth of consumption will wane early next year and pick up again only after the next stage of the tax reduction in mid-1983. The expected increase in real consumer outlays averages about 3-1/2 percent over the next 6 quarters; although substantially faster than the pace of the last 3 years, it is not a particularly strong performance by past cyclical standards.

Recent tax reductions and incentives should result in some improvement in the volume of personal savings. But as the bottom panel indicates, these projections are consistent with a still moderately low saving rate, reflecting in part the less-than-outstanding growth in income.

The next chart addresses the outlook for residential construction. Housing starts have edged upward since their low in the fourth quarter, with a fairly substantial (although not necessarily sustainable) jump in multifamily starts in May. But as the right hand panel indicates, effective demand for new homes remains very weak, largely reflecting continued high mortgage interest rates. We anticipate that high interest rates will continue to be the dominant factor deterring a strong upturn in residential construction activity, although increased use of creative financing and adjustable rate instruments should permit a slightly improved level of activity. As shown in the bottom panel, we are projecting only 1-1/4 million starts for 1983, following a one million total in 1982.

The outlook for business fixed investment is presented in the next chart. Real new orders for nondefense capital goods have dropped sharply in recent months, as shown, and along with recent surveys and other indicators of prospective capital outlays, point to continued weakness in the near term.

We anticipate that capital spending will bottom out near year's end following a cyclical contraction about typical in size. As is evident in the upper right hand panel, new orders for defense capital goods, while erratic, have on average begun to grow in real terms and should be rising strongly as we move into 1983. In addition, the effects of liberalized depreciation should support stronger spending by business, particularly as the economic environment improves. But as shown in the bottom panel, we anticipate a relatively sluggish rebound in 1983--only about a 2 percent rise over the year. This would be well below average for cyclical recovery periods, but consistent with the continued high cost of capital and lack of pressure on available capacity.

The current inventory situation and outlook is portrayed in the next chart. Recent data suggest that a good deal of the inventory adjustment may well have been completed by now. As the top left panel shows, at auto dealers by the end of May inventories of domestic models were reduced to historically normal ranges as a result of drastic production cuts and some improvement in sales.

In manufacturing, shown in the right hand panel, the inventory total in real terms has been brought back down to about the late 1980 level. However, sales have declined as well, and stock-sales ratios remain high, particularly in primary metals and machinery. Overall stock-sales ratios should ease off gradually later this year as demand picks up as we anticipate.

Although we are projecting the end of liquidation later this year, little real inventory investment is expected in 1983 in light of the high cost of carrying stocks, relatively weak markets, and reduced inflation. As shown below, our projections involve a moderate further decline in the inventory-sales ratio.

The next chart presents the government components of spending. While reduced real government purchases have been a drag on activity this year, this should be less true in 1983. The rise in real defense outlays in 1982 lags the pace of the previous two years, but such spending is expected to accelerate again in 1983. Reflecting budget actions, nondefense purchases are projected to decline in both 1982 and 1983, although because of the timing of CCC outlays, the drop is expected to be smaller next year. Real state and local purchases are expected to continue contracting in response to reduced federal support and weak revenues but the drop in '83 should also be smaller than over the previous two years. In combination with the federal sector, this results in a rise in overall government purchases of about 1-1/2 percent in 1983, following a decline of about the same amount expected this year.

As the next chart shows, in line with the sluggish gains in output, we expect relatively weak employment growth over the balance of the projection period. In part, a pickup in demand for labor will likely be met through an increased workweek.

The paucity of job openings should continue to depress labor force growth, as has been the case in other recent periods of weak demands, and no increase is projected for the participation rate. Nevertheless, the rise in the working age population alone will support about a one percent growth in the labor force, close to the projected rise in employment; thus the unemployment rate is expected to edge off only slightly, remaining around 9 percent at the end of 1983.

As the next chart shows, the prolonged period of slack labor markets has paid handsome dividends in an easing of wage inflation. The moderation was first evident in the industrial sector where manufacturing wages dropped from an 11 percent rate of rise in late 1980 to about 8 percent in early 1982. A distinct slowing of the wage rise has been evident this year in the service sectors as well. We expect these trends to continue, given the general easing of price pressures, the environment of sustained high unemployment, and evidence of increased concessions on wages and fringe benefits. As shown in the bottom panel, we project the average hourly earnings index to be rising at about a 5-1/2 percent rate by the end of 1983 as compared to over 8 percent in 1981.

As the top panel of the next chart indicates, we also expect some help from productivity in reducing inflationary pressures. In light of the modest rise projected for production, we do not anticipate a strong cyclical productivity gain--about 1-1/2 percent in 1983. Nevertheless, such an improvement, when combined with the expected reduction in wage pressures, would result in a distinct deceleration of unit labor costs, which are expected to be rising at under a 4 percent rate in the latter half of 1983.

The outlook for inflation is presented in the next chart. The moderation of overall price increases last year owed much to food and energy as is clearly evident in the first two panels. Some resurgence of prices is currently underway in both sectors which is likely to last into early 1983. But fundamentally, the improvement in inflation has reflected reduced pressure from labor costs as well as prolonged slack in product markets. These forces are expected to damp the rise in food and energy sectors and foster improvement in price performance generally. The recent strong position of the dollar in international markets should also help. Overall, we are now projecting that prices will slow to about a 4-1/2 percent rate by late next year.

Mr. Truman will continue with a discussion of the international outlook.

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E.M. Truman
June 30, 1982

FOMC CHART SHOW PRESENTATION -- INTERNATIONAL

The top panel in the first international chart shows the new highs achieved by the foreign exchange value of the U.S. dollar in recent weeks. Although the dollar has declined from the point plotted for Monday, it is well above the peak reached last summer. Indeed, the dollar has recently traded at an average value it last attained prior to August 15, 1971.

As is shown in the lower panel, the differential between short-term dollar interest rates and rates on assets denominated in foreign currencies is somewhat narrower than it was a year ago, but the spread has widened over the past month. A further increase may be generally anticipated since interest rates abroad are expected to continue declining while short-term dollar rates remain high. The recent strengthening of the dollar has been aided also by the rise in international tensions and the problems of particular currencies such as the French franc and Canadian dollar.

While such special factors are important, the fundamental explanation of the dollar's current high value is probably the success of tight U.S. monetary policy in controlling inflation and the promised continuation of that policy in the face of large budget deficits.

The top panel of the next chart illustrates one measure of the relative success of U.S. monetary policy. From mid-1977 until last summer, U.S. consumer prices rose more rapidly than consumer prices on average abroad. Since last fall, prices abroad, while slowing, have risen more rapidly than U.S. prices. Thus, on a price-adjusted basis -- shown by the red line in the lower panel -- the dollar recently has just matched the peak it reached last summer, although on a nominal basis it has surpassed that earlier peak by 3½ percent.

As is shown in the upper left-hand panel of the next chart, consumer price inflation has been moderating on average in the major foreign industrial countries since the middle of 1980. This trend is expected to continue during the forecast period, as is shown in the lower left-hand panel, but will be less dramatic than the projected moderation in U.S. inflation.

The upper right-hand panel shows industrial production on average in the major foreign industrial countries. In mid-1980, production dipped below its level a year earlier. This recession in industrial production continued into late last year, and production dipped again below depressed year-earlier rates in the first four months of this year. Nevertheless, as is shown in the lower right panel, we are projecting a pickup in economic activity abroad for 1982 as a whole that will continue into 1983. But the recovery will be sluggish and unemployment is not likely to decline from its recent high rates.

Many foreign countries are counting on the United States to help pull them out of recession. To examine the strength of these effects we ran a simulation with our Multi-Country Model.

In this simulation, U.S. investment was lowered so as to cut U.S. growth over the next 6 quarters in half -- from an annual rate of about 3 percent to 1½ percent. The model results suggest only moderately lower growth abroad -- about one third of one percent, on average. We also examined the effects of a different mix of U.S. policies -- one producing the same path of U.S. real GNP with higher money growth and lower budget deficits. We found that under the assumption of unchanged policies abroad, growth would be weaker because the depreciation of the dollar that would be associated with the different mix of U.S. policies would reduce U.S. import demand. On the other hand, lower inflation abroad under such a scenario could lead to less contractionary policies.

As matters now stand, the projected pick up in growth abroad is expected to be insufficient to outweigh the continuing adverse effects of the dollar's appreciation on U.S. nonagricultural exports. Consequently, as is shown in the top panel of the next chart, such exports are expected to continue to decline in volume through the middle of next year, for a cumulative decline of more than 25 percent since mid-1980.

Meanwhile, agricultural exports -- the bottom panel -- are expected to show some growth in volume, but little growth in value before the end of this year, when prices may edge up a bit after the market has digested some of the large carryover stocks from the 1980/81 crop year.

On the import side -- the next chart -- a decline in the value and volume of non-oil imports appears to have continued into the second quarter. The negative effects of the recession -- particularly as manifested in substantial inventory liquidation -- have been stronger than the positive influence of the dollar's appreciation, which sustained the volume growth of non-oil imports in 1981. With the resumption of U.S. economic growth, these two factors should be pulling for a while in the same direction, and non-oil imports are projected to expand rapidly.

Oil imports, shown in the lower panel, present a somewhat different picture. The price of imported oil declined to less than $30 per barrel in May -- more than $6 dollars less than a year earlier. As is shown in the box, we have assumed that the average price of imported oil will not reach the 1981 level in 1982 _or_ 1983, although we expect the price to firm toward the official OPEC level of $34 per barrel. Meanwhile, the volume of U.S. oil imports should begin to recover with the rise in aggregate demand. However, the value of oil imports this year is expected to be more than $20 billion below last year, and the projected increase in 1983 is less than $10 billion.

The last international chart summarizes the projection for our international accounts. As is shown in the top panel, the trade deficit in 1982 is projected to be somewhat smaller than the deficit last year, but it is expected to widen to around $60 billion (at an annual rate) in the second half of 1983.

Consequently, the current account balance, shown in the middle panel, swings from a <u>surplus</u> of more than $10 billion at an annual rate in the first half of this year to a deficit of about $30 billion in the second half of next year. We expect that by 1983 the growing U.S. current account deficit should exert a substantial negative influence on the dollar's international value; our projection also is based on the expectation that the dollar will decline somewhat in the second half of this year from its recent very high levels.

In terms of the GNP accounts -- the bottom panel -- real exports of goods and services will continue to exert a negative influence on economic activity into early 1983, while imports should pick up next quarter.

Mr. Kichline will now complete our presentation.

James L. Kichline
June 29, 1982

CHART SHOW -- CONCLUSION

The first chart in the last section of your packet presents broad summary measures of the credit variables consistent with the staff's economic forecast. The top line of the chart shows that total funds raised by domestic nonfinancial sectors as a percent of GNP fell appreciably from the recent peak in 1978 through last year, a usual occurrence in periods of financial restraint. For this year and next we are expecting pressures on markets to keep the total near the level reached in 1981, which implies small expansion in the absolute dollar volume of funds raised--as shown in the box at the right. But there are marked changes projected in the composition of borrowing, with the Treasury commanding nearly one-half of the total in 1983. Even as a percent of GNP, the lower line in the chart, Treasury borrowing at over 6 percent next year would be at an unprecedented peacetime level.

The squeeze on markets from the Treasury we expect will be one of the important forces acting to damp the volume of funds raised by private sectors. The business sector, shown on the next chart, has cut back substantially on its investment expenditures in the first half of this year and the recovery in outlays projected next year still leaves the level below that in 1981. Profits, the top right panel, have been depressed by the recession, especially before taxes, although we anticipate expansion of profits later this year and next as sales pick up and businesses maintain tight control over costs.

The lower left panel displays the financing gap which plunged in the first half of this year as expenditures dropped more than cash flows; the forecast suggests little change in the gap through 1983. So far this year, however, corporate borrowing has been exceptionally strong relative to this measure of needs, and the sector in total apparently has piled up liquid assets. These developments are somewhat puzzling and may reflect, in part, a severe disparity of financing needs among individual corporations and perhaps weaker profits and cash flows than the available information suggests. In any event, we expect a moderation of borrowing and a halt in the rise of the ratio of short-term to total debt outstanding--the right panel. But with interest rates still high, and firms unable or unwilling to tap long markets in volume, we expect a degree of strain on balance sheets to persist.

In the household sector, the next chart, real disposable income has held up rather well during the recession, helped by the personal tax cuts last year. Household debt burdens, the right panel, eased over the past few years as consumers reduced their installment and mortgage borrowing. Over the next year and a half we expect debt burdens in the aggregate will remain quite manageable, given moderate borrowing expected in line with only limited improvement in the auto and housing markets.

An improved financial position of households is supported by the relatively low rate of short-term loan delinquencies, as indexed by auto loans in the lower left panel. Tightened lending standards and the high turnover of installment lending has led generally to a considerable improvement in short-term loan portfolios since 1980 despite the recession. But the same is not true in the mortgage area, shown in the right panel. There is reason for concern here, especially in view of the growth of various creative financing arrangements. It seems likely that disappointment will set in for those who undertook commitments with a view that in the near term they would be bailed out by large capital gains and sharply reduced mortgage interest rates.

In general, there are major downside risks to the economy stemming from the financial side of the outlook. Adjusting to a situation of declining inflation and high interest rates will continue to place strains on some households, businesses, and financial institutions.

The last chart in the package displays the forecasts of FOMC members for 1982 and 1983 along with the staff forecast. The figures generally are rather close, although for 1983 the staff's forecast of the deflator tends to be the most optimistic. At this time we only have tentative figures for the administration's forecast which is scheduled to be reported to the Congress in mid-July. Their forecast is within the range of FOMC members for 1982, but not for 1983. They now have nominal GNP projected at 10½ percent next year, with real growth of 4½ percent and a deflator of 5-3/4 percent; the unemployment rate at the end of 1983 is projected to be 8½ percent.

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